

COMMENTARY

Comments by the Auditing Standards Committee of the Auditing Section of the American Accounting Association on the International Monitoring Group Consultation, *Strengthening the Governance and Oversight of the International Audit-Related Standard-Setting Boards in the Public Interest*

Participating Committee Members:

Denise Dickins, Marcus M. Doxey, Marshall A. Geiger, Christine Nolder, Pamela B. Roush

SUMMARY: On November 9, 2017, the Monitoring Group (MG) overseeing international auditing standards issued a request for comment on its consultation paper (CP), *Strengthening the Governance and Oversight of the International Audit-Related Standard-Setting Boards in the Public Interest*. The CP presents a broad array of proposals to reform and restructure the three current auditing standard-setting groups it oversees (International Accounting and Assurance Standards Board [IAASB], International Ethics Standards Board for Accountants [IESBA], and International Accounting Education Standards Board [IAESB]). The CP suggests combining the three boards into a single board, and solicited public comment on the following areas: (1) key areas of overall concern, (2) guiding principles, (3) options for reform of the standard-setting boards, (4) options for the Public Interest Oversight Board (PIOB), (5) role of the monitoring group, (6) administration, including Standard-Setting Board staff, (7) process

The views expressed in this comment letter are those of the participating members of the Auditing Standards Committee and do not reflect an official position of the American Accounting Association or the Auditing Section. In addition, the comments reflect the overall consensus view of the Committee, not necessarily the views of every individual member.

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considerations, and (8) funding. The comment period ended on February 9, 2018. This commentary summarizes the participating committee members' views on selected questions for respondents posed by the MG.

Data Availability: The concept release, including questions for respondents, is available at: <https://www.iosco.org/library/pubdocs/pdf/IOSCOPD586.pdf>

RESPONSES TO SELECTED QUESTIONS IN THE CONSULTATION PAPER

Question 1: Do you agree with the key areas of concern identified with the current standard-setting model? Are there additional concerns that the Monitoring Group should consider?

We agree that there are potentially two overarching perceptual concerns with the current standard-setting model identified in the Consultation Paper (CP) that, if addressed, might strengthen public confidence in the standard-setting process and encourage wider global adoption of the International Standards on Auditing (ISAs). The first concern is whether stakeholders view professional involvement in the International Federation of Accountants (IFAC) standard-setting process as a potential conflict of interest leading to independence problems. The second is whether stakeholders consider the IFAC standard-setting process to be nonresponsive to their needs in a timely and effective manner.

As reported in the CP, the Monitoring Group (MG) interviewed a variety of stakeholders and identified a concern that existing auditing standards may not serve the public interest due to the public accounting profession's significant involvement in the standard-setting process. To address this concern, the MG is proposing to create a more independent standard-setting process. However, we believe that additional empirical validation of this concern would increase support of the MG's proposal and would help ensure that the goal of long-term sustainability of standard setting is achieved. For example, it would be helpful if the CP identified more clearly the groups, and the proportions within the groups, that perceive that the current level of the profession's involvement in the standard-setting process is inappropriate. In "Appendix 2: Stakeholders Views of Governance SSB," the MG describes some of the procedures used to identify perceived deficiencies of the current system, but no empirical support is offered as to the number and types of stakeholders interviewed and how the information obtained supports the conclusions reached. How were the interviewed individuals identified? Were they only the self-selected individuals that had voiced concerns regarding the process who were then captured in the data, or was there a random selection of representatives from different stakeholder groups identified and surveyed? Without transparent evidence of where the concerns emanate or any indication of systematic analysis to support the CP's assertions of widespread perceptual issues, readers of the CP are left to question the MG's conclusions.

We agree that a large portion of the independence concern is likely because of the global professional accounting community's provision of staff, funds, management, and technical support for the standard-setting boards of the IFAC. We acknowledge that this arrangement has the potential to erode stakeholder confidence by possibly creating a perception of "regulatory capture," where the regulated profession essentially controls their regulators (cf. [Becker 1983](#)).¹ Structurally

¹ Regulatory capture refers to instances where a profession that is subject to regulation and oversight by an independent regulator maintains such close interactions and ties with their regulator that they effectively control the actions and decisions of that regulator ([Kalt and Zupan 1984](#); [Becker 1983](#); [Stavros 2012](#); [Wilmarth 2013](#)).

removing or drastically reducing the profession's involvement in the management, staffing, and funding of the IFAC's standard-setting boards is an option that appears to address the risk of undue professional influence. However, because the IFAC is a privately funded organization, designing an alternative structure to professional support that is economically and operationally feasible would be a significant challenge. In conclusion, even though we agree that the IFAC's financial and managerial ties to the profession is a potential concern, we also acknowledge the challenge that eliminating this support poses to the IFAC's efforts to restructure the current standard-setting process.

With respect to the second potential perception issue regarding standards issued by the IFAC objectively meeting the needs of stakeholders, we believe that the MG should perform or commission a study of recently released auditing standards in order to determine whether the adopted standards appear to be systematically favorable to the public accounting profession, biased against financial statement users, or slanted in favor of or against any other stakeholder group. Is there evidence in the actual standards that suggests the IFAC is, in fact, subject to regulatory capture by the public accounting firms it was intended to regulate? For example, see the research by [Brown \(1981\)](#) and [Brown and Feroz \(1992\)](#) for illustrations of research addressing questions of standard-setter bias during the early days of the Financial Accounting Standards Board (FASB) in the United States. We have not seen similar oriented research applied to the IFAC's auditing standards that have been promulgated using the current process.

In addition, it would also be helpful to identify specific instances or standards where members of the public accounting profession inappropriately influenced the standard-setting process, which led to standards that were not of the highest quality. Are there instances where an auditor *adhering to standards* failed to execute a quality audit? If so, which stakeholder groups feel this way? Without such information, we believe that the MG has not established a clear need for systemic change in the CP.

Our primary concern in any restructuring of the current standard-setting model is the consideration of how a new framework can improve the relevance and timeliness of standards to promote and improve audit quality and user confidence. We agree that the standard-setting process should utilize public consultation feedback on whether changes are necessary and, if so, whether the changes will be more effective than the current process. We encourage the MG and IFAC to pursue a framework for the development of new standards that results in promulgating high-quality auditing standards in timely manner. We also agree with the MG's plans to incorporate stakeholder views on possible unintended consequences flowing from any adopted revisions. Additionally, we support reform and outreach efforts that enhance transparency and public understanding of the governance structure to generate greater understanding and wider accountability to stakeholders.

It is also important to note that although the IFAC is not completely independent, it has responded to several potential weaknesses in existing auditing standards. For example, in 2016 the *Code of Ethics for Professional Accountants* was revised to address identified concerns related to auditor independence. In 2006, ISA 240, *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements*, was revised to require specific fraud-detecting auditing procedures.² In 2015, ISA 570, *Going Concern*, was modified to reflect additional considerations and disclosures related to auditors' assessments regarding the going concern assumption. Consequently, it is unclear that the existing standard-setting process is functioning poorly.

² A study in The Netherlands identified evidence that auditors fail to comply with some important elements of fraud standards ([Hassink, Meuwissen, and Bollen 2010](#)).

Question 2: Do you agree with the overarching and supporting principles as articulated? Do you, and why do you, agree with the supporting principles?

Defining what is meant by *the public interest* is integral to setting policy that will guide the development of the framework. Enhancing the public trust begins with a thorough understanding of what does and does not constitute *the public interest*, and what are the implications of this as an overarching principle (Dellaportas and Davenport 2008). The public interest is not served simply by stating it is an overarching principle without clearly defining it.

We believe the two endeavors of defining the principle and developing a framework based on the principle are interrelated and should be addressed simultaneously at both the policy level and the operational level. However, the first step in developing and then operationalizing a framework is to clearly define the overarching principles for the framework. While most of the principles (independence, credibility, cost effectiveness, and transparency) are clearly defined, the definitions for public interest, relevance, and accountability need to be improved. Stating that public interest is served when “the structure ensures that standard setting is undertaken in the public interest” does not articulate a clear meaning, is extremely broad, and appears to overlap with the principle of “relevance.” How is the principle of “relevance,” which reflects standard setters’ responsiveness to the needs of the market and the users of financial statements, different from serving the public interest? The definition of accountancy where “decision makers should be accountable to the public interest” is also reliant on the meaning of the principle of public interest. In addition, how does the principle of “public interest” differ from that of “investor protection,” which is used by the PCAOB in the U.S.? Is it broader than “investor protection” and, if so, what other areas of the “public” is it intended to encompass?

We also recognize that there is no single meaning or approach to defining “public interest,” and researchers in accounting and elsewhere have identified a multitude of approaches to defining this construct.³ Nonetheless, weak definitions of terms and principles create ambiguity in the

³ For example, Dellaportas and Davenport (2008) suggest that viewing *the public interest* as a concept inadequately defines a principle that must stand as a measure of public policy. They encourage us to ask who exactly is the public, what are the interests of the public, and what does it mean to serve the public interest? We encourage you to address these questions before you construct a definition and use it as the overarching principle of the framework.

Dellaportas and Davenport (2008) suggest using the typology of public interest theories developed by Cochran (1974) to explore the meaning of the public interest as it is commonly understood in accounting. Cochran’s (1974) classification of public interest theories include the normative, consensualist, process, and abolitionist. He uses two defining characteristics to distinguish the theories: (1) the extent to which the theory relies on an ideal or ethical standard to explain the meaning of the public interest; and (2) the constituents that define the public, which can be defined as a whole (or the majority of the whole), part of the whole (special interests), or no public at all (Dellaportas and Davenport 2008).

Definitions of the public interest based on normative concepts use ethical standards to guide public policies that will maximize the collective well-being of the community. For example, the normative perspective focuses on whether policies directly affecting primary users of financial reports have the propensity to enhance the general well-being indirectly by improving the economic decisions that creates economic activity and wealth.

Definitions of the public interest based on abolitionist, process, and consensualist principles may consider morals in policy debate, but the focus of the enhancement of the public interest is for a significant proportion of the population rather than the entire group. Public interest definitions based on this group of principles derive their meaning on policy actions that advance special interests or define the processes to resolve conflicts. Consensualist theorists define the public as a relatively large number of people, but not the whole community. Serving the wider community of stakeholders espoused by the normative definition is viewed as a practical limitation. When accounting and auditing standards limit the scope of the public to primary users of accounting information, such policy is based on the consensualist notion of the public interest.

messaging of the CP regarding responsibilities and relationships between standard setters, the accounting profession, and members of the general public as to what is the public interest (Lindblom and Ruland 1997). In sum, the absence of a clear definition of the public interest weakens the framework by not allowing a clear assessment of how the public interest is addressed, or its needs incorporated into the standard-setting process.

Instead of grounding the framework in a principle of “public interest,” consider using “*audit quality*” as the primary guiding principle for effective standard setting, as argued further in Nolder and Palmrose (2018). We believe that if audit quality were the guiding principle, then any improvements in audit quality would benefit the public interest in general and investors more specifically. Put another way, we support the use of a framework that *operationalizes* the principle of the public interest as the attainment of *high-quality audits*. The stated purpose of the standard-setting framework is to increase the confidence of users in financial statements and support the integrity of financial markets through the delivery of high-quality audits.

Question 3: Do you have other suggestions for inclusion in a framework for assessing whether a standard has been developed to represent the public interest? If so, what are they?

As suggested in response to Question 1, we believe that standard setting should be *evidence based*. That is, the onus is on the regulator to provide evidence that a problem exists with either audit quality, or perceived audit quality, and standard setting is a warranted and justifiable response, as opposed to alternative solutions such as issuing implementation guidance or having firms adjust their audit methodologies (cf. Nolder and Palmrose 2018).

As noted previously, it is in the best interest of the public, other stakeholders, and auditors, when promulgated standards are effective in achieving improved audit quality. Those standards must also lend themselves to proper application by auditors and enforcement by regulators. We are not clear how these implementation and enforcement objectives would be operationalized in the proposed new framework.

The MG may also consider different standard-setting processes for different types of standards. For example, Nolder and Palmrose (2018) examine existing PCAOB auditing standards and propose the rudimentary stages of a framework that differentiates the regulatory approach to standard setting contingent upon on the type of auditing standard expected as the outcome. They parsimoniously categorize PCAOB audit standards into three types of standards: “(1) auditor performance standards that are primarily designed to affect auditors’ behavior and,

Process theories of the public interest are generally concerned with policy that promotes due process to guide members on how to serve the public interest. An in-depth understanding of the public interest is a critical element for policy, rather than an ethical standard. For process theorists the public entails competing groups with diverse interests. The theory focuses on procedures that transform conflicts into policies or actions that promote the public interest.

Abolitionist theories deny the notion of the public or an ethical standard based on altruism and consider only immediate self-interests. Similar to the interactionist perspective, the public interest is advocated if it supports the profession’s self-interest. Under these theories professionals use their expertise and authority to abuse the trust that society has placed in them, most often to “advance their own interests at the expense of those they serve” (Frankel 1989, 110). The creation of the Public Company Accounting Oversight Board by the U.S. Congress to replace self-regulation of the audit profession (auditors of publicly traded companies) demonstrates the need for disciplinary enforcement and accountability to guard against abolitionist and interactionists versions of the public interest. Our “watch dog” image to protect the public interest is essential to the existence of a profession like public accounting.

thereby, improve audit quality; (2) auditor disclosure standards that are primarily designed to give investors more or different information pertaining to audit quality and/or the quality of financial reporting; and (3) standards (rules) for the practice of auditing (e.g., auditor independence rules) that are primarily designed to establish ‘rules of the road’ for individual auditor and audit firm activities and relationships and, thereby, maintain or improve audit quality and/or perceptions of (confidence in) audit quality” (Nolder and Palmrose 2018). They argue that each type of standard has unique features that warrant different considerations in the standard-setting process and, thus, warrant slightly different standard-setting approaches for each type of standard.

We note that the current standard-setting processes utilized by the three current boards overseen by the MG (i.e., Auditing and Assurance, Ethics, and Education) appear to broadly address these concerns regarding using a single standard setter, or a single standard-setting process. Accordingly, we do not recommend that international standards for auditing and assurance, ethics, and education be promulgated by a single standard setter utilizing the same standard-setting process across these three different types of standards.

Question 8: Do you agree that the focus of the board should be more strategic in nature? And do you agree that the members of the board should be remunerated?

With respect to remuneration for board members, we generally believe that board members should be fully compensated for the time devoted to this important process. Participating on any of the three boards under the MG requires a tremendous amount of time and energy to perform at a high level. This becomes even more important if the new framework incorporates “full-time” board members. We are aware that IAASB board members are currently expected to commit to over 1,000 hours of unpaid participation. This is a very significant time commitment on the part of these individuals. In addition, we are also aware that at least one current academic IAASB board member receives no reduced teaching load at their home university. These 1,000+ hours are often hours spent in addition to fulfilling other full-time employment responsibilities. Arousal and other performance theories generally support an inverted U-shaped reward-to-effort effect; without remuneration, performance tends to be low (see Bonner and Sprinkle 2002). Accordingly, we generally believe remuneration is appropriate.

Question 10: Do you agree with changing the composition of the board to no fewer than twelve (or a larger number of) members; allowing both full-time (one quarter?) and part-time (three quarters?) members? Or do you propose an alternative model? Are there other stakeholder groups that should also be included in the board membership, and are there any other factors that the Monitoring Group should take account of to ensure that the board has appropriate diversity and is representative of stakeholders?

One of the goals of the proposed changes is to ensure independence of the standard-setting process. To this end, the CP suggests a multi-stakeholder board requiring equal representation of “three groups—users (including investors, preparers, academics, and those charged with governance), regulators ... and auditors.” If the MG pursues this approach, we believe it would better serve the public interest to expand the number of separate groups requiring representation. By including both investors and preparers under one umbrella, the CP suggests the interests of these two groups align enough to be represented as one stakeholder group. Research does not support combining these groups; the “users” group, as listed, is too broadly defined and should be

further separated (e.g., Jensen and Meckling 1976; Shleifer and Vishny 1997; Watts and Zimmerman 1983).

Agency theory research in accounting, economics, and finance all find that it can be difficult to align the interests of investors and preparers (e.g., Jensen and Meckling 1976; Fama 1980; Dey 2008) and often requires strong contracting and investor protections to achieve such an aim (Core and Guay 1999; Shleifer and Vishny 1997). Further, the purpose of auditing is to mitigate the conflicts of interest and information asymmetry that exist between these two distinct groups (e.g., Dey 2008; Francis and Wilson 1988; Hope, Langli, and Thomas 2012; Ng 1978; Watts and Zimmerman 1983). Therefore, it seems reasonable to separate representation for these two groups to ensure that both groups' interests are adequately and accurately represented.

Also, at the risk of appearing self-serving, we humbly suggest that academics have a distinct role to play in developing standards that serve the public interest, and they would be a valuable addition to the thought leadership on the board. We note that each of the stakeholder groups listed in the proposal have distinct biases and incentives regarding audit standard setting because the outcomes directly affect each of the groups, except academics (Álvarez, Calvo, and Mora 2014; Fülbier, Hitz, and Sellhorn 2009). Even regulators have missions that can bias them toward a particular standard-setting result. For example, the PCAOB indicates that its mission is “to protect the interests of investors” (<https://pcaobus.org/About/History/Pages/default.aspx>), which clearly elevates the interests of one group. In contrast, while it would be naïve to suggest that academics could not be biased, audit standards do not directly affect academia's mission and core functions. Academia's mission is typically fulfilled by the creation and dissemination of knowledge. In fact, Álvarez et al. (2014) explicitly note academics' lack of incentives to engage in the standard-setting process as one reason for research's minimal impact on standards (see, also, Fülbier et al. 2009). This barrier to robust participation points to a strength of academic participation—the lack of incentives for academics means that they are not as likely to bias their input (1) toward a particular outcome, or (2) for or against a particular stakeholder group. This gives academics the unique position of having both sufficient knowledge to weigh in on standard-setting debates and the independence to do so (see Schipper [2010] for a frank discussion of some applications and limitations of academic research in the standard-setting process).

Further, we contend that standard setting can be improved when informed by quality research (Álvarez et al. 2014; FASB 1991; Fülbier et al. 2009; Humphrey, Loft, and Woods 2009; Leisenring and Johnson 1994; PCAOB 2018). Álvarez et al. (2014, 786) find that “the opinions of academics add valuable input to the [standard-setting process], as their opinion is practically absent in the comment letters and . . . different to the opinion of preparers and auditors, at least in some topics.” Academics, being trained producers and consumers of research, are well qualified to find and appropriately interpret any extant research pertinent to policy considerations (Fülbier et al. 2009; Leisenring and Johnson 1994). We also note that the Financial Accounting Standards Board (FASB) in the U.S. has long included a board member appointed from academia, and the PCAOB's Standing Advisory Group (SAG) includes several (currently four out of 34) academic members.

Based on the above, we propose that the Monitoring Group consider expanding board representation from the three named groups (users, regulators, and auditors) to at least five stakeholder groups comprised of users, preparers, academics, regulators, and auditors, with at least one representative from each of these groups.

Table 1 presents the questions not responded to in our letter.

TABLE 1
Questions Not Responded to in Our Letter

Question

- 4 Do you support establishing a single independent board, to develop and adopt auditing and assurance standards and ethical standards for auditors, or do you support the retention of separate boards for auditing and assurance and ethics? Please explain your reasoning.
- 5 Do you agree that responsibility for the development and adoption of educational standards and the IFAC compliance program should remain a responsibility of the IFAC? If not, why not?
- 6 Should the IFAC retain responsibility for the development and adoption of ethical standards for professional accountants in business? Please explain your reasoning.
- 7 Do you believe the Monitoring Group should consider any further options for reform in relation to the organization of the standard-setting boards? If so please set these out in your response along with your rationale.
- 9 Do you agree that the board should adopt standards on the basis of a majority?
- 11 What skills or attributes should the Monitoring Group require of board members?
- 12 Do you agree to retain the concept of a CAG with the current role and focus, or should its remit and membership be changed, and if so, how?
- 13 Do you agree that task forces used to undertake detailed development work should adhere to the public interest framework?
- 14 Do you agree with the changes proposed to the nomination process?
- 15 Do you agree with the role and responsibilities of the PIOB as set out in this consultation? Should the PIOB be able to veto the adoption of a standard, or challenge the technical judgements made by the board in developing or revising standards? Are there further responsibilities that should be assigned to the PIOB to ensure that standards are set in the public interest?
- 16 Do you agree with the option to remove IFAC representation from the PIOB?
- 17 Do you have suggestions regarding the composition of the PIOB to ensure that it is representative of non-practitioner stakeholders, and what skills and attributes should members of the PIOB be required to have?
- 18 Do you believe that PIOB members should continue to be appointed through individual MG members or should PIOB members be identified through an open call for nominations from within MG member organizations, or do you have other suggestions regarding the nomination/appointment process?
- 19 Should PIOB oversight focus only on the independent standard-setting board for auditing and assurance standards and ethical standards for auditors, or should it continue to oversee the work of other standard-setting boards (e.g., issuing educational standards and ethical standards for professional accountants in business) where they set standards in the public interest?
- 20 Do you agree that the Monitoring Group should retain its current oversight role for the whole standard-setting and oversight process including monitoring the implementation and effectiveness of reforms, appointing PIOB members and monitoring its work, promoting high-quality standards, and supporting public accountability?
- 21 Do you agree with the option to support the work of the standard-setting board with an expanded professional technical staff? Are there specific skills that a new standard-setting board should look to acquire?
- 22 Do you agree the permanent staff should be directly employed by the board?

(continued on next page)

TABLE 1 (continued)

Question

- 23 Are there other areas in which the board could make process improvements—if so what are they?
- 24 Do you agree with the Monitoring Group that appropriate checks and balances can be put in place to mitigate any risk to the independence of the board as a result of it being funded in part by audit firms or the accountancy profession (e.g., independent approval of the budget by the PIOB, providing the funds to a separate foundation or the PIOB, which would distribute the funds)?
- 25 Do you support the application of a “contractual” levy on the profession to fund the board and the PIOB? Over what period should that levy be set? Should the Monitoring Group consider any additional funding mechanisms, beyond those opt for [sic] in the paper, and if so what are they?
- 26 In your view, are there any matters that the Monitoring Group should consider in implementation of the reforms? Please describe.
- 27 Do you have any further comments or suggestions to make that the Monitoring Group should consider?

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